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IN THE
Supreme Court of the United States
OCTOBER TERM, 1984

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
Petitioner,

V.

STATE OIL & GAS BOARD OF MISSISSIPPI,
ET AL.,
Respondent.

On writ of certiorari to the
Supreme Court of Mississippi

BRIEF OF AMICUS CURIAE,
THE LEGAL FOUNDATION OF AMERICA

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BRIEF OF AMICUS CURIAE, THE LEGAL FOUNDATION OF AMERICA

INTEREST OF AMICUS CURIAE

The Legal Foundation of America ("LFA") is a nonprofit corporation supporting the operations of a public interest law firm. It has expertise in matters of energy policy and frequently files briefs in energy cases. LFA is located on the campus of, and shares certain activities and personnel with, the South Texas College of Law in Houston.

SUMMARY OF ARGUMENT

I.

Preemption and Commerce Clause Issues. The rule at issue is not preempted by the Natural Gas Act or Natural Gas Policy Act. With respect to this deregulated gas, today's legislative policy is unrelated to (and is only indirectly affected by) the objectives of this Mississippi rule. Nor is this rule prohibited by the negative commerce clause. The rule is non-discriminatory; it seeks to protect important local interests that are not addressed at all by federal law; and its goals could not be equally achieved by lesser means.

Ratable "Production" as Opposed to Ratable "Take". Ratable "production" is not in a status that is preferred to ratable "take" under the Constitution. The legislative choice between the two approaches is exceedingly complex. Arguments by pipeline purchasers and by producers reflect different resolutions of the competing equities. Thus Mississippi was justified in concluding that its policy goals could be achieved by a system of ratable take, but not by one of ratable production. Furthermore, since Mississippi does not attempt to regulate the price at which a pipeline must take, this rule does not interfere with a purchaser's ability to limit its takes to gas it knows it can profitably resell, and thus it does not burden interstate commerce.

II.

Avoidance of Endorsement of Burdensome State Rules. Although the Court should uphold the rule at issue, it should avoid broad endorsement of state rules that might unduly burden gas purchasers. In particular, a purchaser should not be required to take at identical prices from all sellers irrespective of sale conditions. Such a requirement would not be "non-discriminatory." Instead, it would be irrational, since it would prevent the purchaser from considering market circumstances affecting price.

ARGUMENT AND AUTHORITIES

I. NEITHER THE NGPA NOR THE NEGATIVE COMMERCE CLAUSE PREVENTS A STATE FROM PREVENTING WASTE, DRAINAGE OR INEQUITY IN THE PRODUCTION OF NATURAL RESOURCES.

If a single pipeline in a field decides to take from only one among many wells, it will cause drainage of other wells owing to the phenomenon of migration.[1] The law of oil and gas in

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1 E.g., 1 H. WILLIAMS & C. MEYERS, OIL & GAS LAW sec. 204.3-.4 (1983).

the United States embodies the rule of capture, and adjacent mineral owners are bound to protect their correlative rights. Absent a rule such as the one at issue, these adjacent owners would be unable to produce and sell gas, and they would see gas that lies under their leases produced by the one producing well.[2] Worse, they would suffer a loss of pressure that would ultimately prevent their producing even the gas that remains.

Concerns related to waste and conservation may be affected by these issues. The ultimate effect of reasoning that would reverse this rule would, by the same logic, prevent States from enforcing long-standing rules of conservation. Conversely, if a State can enforce rules relating to field spacing and production allowables,[3] it is difficult to see why it cannot enforce non-discriminatory rules relating to takes from wells by pipelines. Rather than minimizing the role of the States in the regulation of production and pricing of natural gas, Congress, by enacting the Natural Gas Policy Act, expressly

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2 Id. at sec. 204.6; see also Kuntz, Correlative Rights of Parties Owning Interests in Common Sources of Supply of Oil & Gas, 17 INST. ON OIL & GAS TAX'N 217 (1966). Correlative rights are rights to be protected from uncompensated drainage. For an excellent analysis in the context of the Texas proration system, see Note, Natural Gas Regulation and Vested Property Interests: Ratable Taking, Proration Standards, and Fieldwide Civil Liability, 62 TEXAS L. REV. 691 (1983).

3 Thus, for example, field spacing rules may have a substantial indirect or peripheral impact upon pricing, in the sense that if they were suddenly invalidated and if it were made permissible for every producer to locate wells wherever it desired, there might be temporary reductions in cost of production and hence downward pressure on price. The conservation effects, however, would be catastrophic, as would the inequities inflicted upon adjacent producers, and these effects would soon be felt in long-term price increases.

Such local regulations should not be unconstitutional owing to their indirect effect on price, and neither should ratable take rules.

recognized the power of the States to regulate certain prices (*see* NGPA sec. 602) [4] and certain production-related functions such as the determination of qualification for wellhead pricing categories (*see* NGPA sec. 503). [5]

A. The Rule at Issue is Not Preempted by the Natural Gas Act or Natural Gas Policy Act

Nothing in the NGPA or the NGA prevents the rule at issue. The NGPA contains a complex scheme of price ceilings for wellhead sales of different categories of gas, depending upon the dates when wells were drilled, upon production formations, upon well location, and upon other factors.[6] The NGPA also provides for deregulation (*i.e.*, removal of price ceilings) of certain categories of gas. While the NGA contains provisions regulating the pricing of gas by natural gas companies (including purchased gas allowances and other aspects of pipeline rate design), [7] its provisions with respect to wellhead sales of deregulated gas are supplanted by the NGPA. Thus the reasoning of *Northern Natural Gas Co. v. State Corporation Commission of Kansas*, 372 U.S. 84 (1963), is inapplicable here. [7a]

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4 15 U.S.C. sec. 3432 (1982).

5 15 U.S.C. sec. 3413 (1982).

6 NGPA secs. 102-109, 15 U.S.C. secs. 3312-3319 (West Supp. 1984). The gas at issue is section 107 gas, which was deregulated in 1979.

7 15 U.S.C. sec. 717f(c) (1982). See generally Pierce, Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry, 97 HARV. L. REV. 345 (1983).

7a The Northern Natural Case was based upon preemption by NGA sec. 1(b).

Section 601(a)(1)(B) of the NGPA, however, declares that "section 1(b) of the Natural Gas Act, the provisions of such Act and the jurisdiction of the [Federal Energy Regulatory] Commission under such Act shall not apply" to, among others, the category of gas defined in section

Similarly, wellhead price deregulation does not embody such a pervasive Congressional judgment against regulation of any kind as to preempt the rule at issue. The Congressional scheme has been interpreted in slightly different contexts to permit state environmental and intrastate pricing regulation. *Pacific Gas & Electric Co. v. State Energy Resources Conservation & Development Commission*, 103 S.Ct. 1713 (1983); *Energy Reserves Group v. Kansas Power & Light Co.*, 459 U.S. 400 (1982). Especially given the inclusion in the statute of explicit authorization of re-regulation[8] and the retention of many categories of regulated gas,[9] the NGPA cannot be said to "imply an authoritative federal determination that the area [i.e., takes of deregulated gas] is best left *un*regulated" even to the extent of prohibiting state rules *unrelated* to price. *Cf. Arkansas Electric Cooperative Corp. v. Arkansas Public Service Comm'n*, 103 S. Ct. 1905, 1912 (1983). In summary, the NGPA structure of national prices, and its scheme of price deregulation that is intended to effect the orderly transition to a market system, are not in the least inconsistent with state rules designed to protect local interests in equity among participants or in conservation. A preemption argument based upon such a claimed inconsistency, when considered in the context of the important role discussed above that the NGPA assigns to the States in connection with deregulated gas, would throw out the baby with the bath water.[9a]

107(c)(1) of the NGPA (which is the category here at issue). 15 U.S.C. sec. 3431 (a)(1)(B)(i) (1982).

Thus the NGPA squarely states that the federal regulation deemed preemptive in Northern Natural "shall not apply" to this gas.

8 15 U.S.C. sec. 3332 (1982).

9 Section 104, for example, provides for a variety of ceiling prices for "old" interstate gas. 15 U.S.C. sec. 3314 (1982). See Nordhaus, Producer Regulation and the Natural Gas Policy Act of 1978, 19 NAT. RES. J. 830, 850 (1979).

9a The decision of the issue in question has significant potential for invalidation of necessary regulation in various States under differing statutory systems. See Court to Decide Gas Sales Authority—Jurisdiction of Natural Gas Sales to Pipe-

Nor does FERC authority over purchased gas allowances preempt this state rule, because wellhead sales and pipeline sales have always been the subjects of separate regulatory schemes, and any effect on purchased gas allowances would be indirect and incidental. The state rule at issue does not make federal compliance "a physical impossibility," and it does not "stand as an obstacle" to FERC's objectives with respect to purchased gas allowances, as would be required for preemption in the absence of express language. *Pacific Gas & Electric Co., supra*, 103 S. Ct. at 1722.[10]

B. The Rule at Issue is Not Prohibited by the Negative Commerce Clause

Further, the state rule is not prohibited by the negative commerce clause. The modern rule of *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970), clearly indicates that it should be upheld. First, the rule at issue does not discriminate against interstate commerce; it is, in this respect, "even-handed." *Id.* The effects it will have on interstate commerce are "incidental"

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lines at Stake, Okla. J., Mar. 26, 1985, at 1, col. 2; Paschal, Hearing Examines Gas Ratable Take Powers, The [Okla.] Journal—Record, Oct. 18, 1984, at 2, col. 1.

The Oklahoma Commission decided that its ratable take system (which differs from Mississippi's in that it is combined with a proration system) was constitutional even in light of Northern Natural, as did the Texas Railroad Commission. See APPENDIX and authorities therein cited.

10 See note 3 supra.

Thus preemption is "not favored 'in the absence of persuasive reasons–either that the nature of the regulated subject matter permits no other conclusion, or that Congress has unmistakably so ordained.'" Chicago & N.W. Transp. Co. v. Kalo Brick & Tile Co., 450 U.S. 311, 317 (1981), quoting Florida Lime & Avocado Growers v. Paul, 373 U.S. 132, 142 (1963). Preemption does not extend to state regulation that is "peripheral" to the federal objective, 450 U.S. at 317, quoting San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236, 243 (1959), or to a subject that is amenable to local regulation and that is one that Congress could have regulated but did not. 450 U.S. at 317.

in the sense that they are not the direct object of the rule and they need not be significant in relation to other factors affecting interstate commerce. *Id.* There is a "legitimate local purpose" in the prevention of waste, drainage, and inequity. *Id.*

Given these conditions, the question becomes "one of degree," according to *Bruce Church.* The extent of the burden that will be tolerated depends on two factors: (1) "the nature of the local interest involved" and (2) "whether it could be promoted as well with a lesser impact on interstate commerce." *Id.*

The local interest is strong, in that absent some sort of state intervention, the issues of drainage and waste of natural resources simply would not be addressed by any law. Neither is the subject of federal regulatory protection (nor should either be). [11] The protection and preservation of natural resources is a state interest of the first magnitude, *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456 (1981), as is the regulation of local actions of businesses affected with the public interest, *Munn v. Illinois*, 94 U.S. 113 (1876); *see also Railroad Comm'n Cases*, 116 U.S. 307 (1886). Furthermore, as the Mississippi Supreme Court pointed out, it is entirely appropriate for the State to address preventable inequities due to these issues.

C. "Ratable Production" Should Not be Constitutionally Preferred Over Ratable Take

The issue remains whether the local interest "could be promoted as well with a lesser impact on interstate commerce." *Bruce Church, supra*, 397 U.S. at 142. It has been suggested that a lesser impact could result if Mississippi used "ratable production" limits rather than ratable take requirements. Ratable production limits the producer, while ratable take limits the

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11 See note 10 supra.

pipeline.[12] It is respectfully submitted, however, that ratable production can itself have dysfunctional effects. The subject is controversial, and the propriety of ratable production is currently the subject of pending litigation.[13] The Court should not require States to adopt it as a matter of constitutional law.

(1) Pipeline Arguments. The argument of pipelines in favor of ratable production concerns the interplay between take-or-pay clauses, ratable take, and production by a number of producers within a single field. A take-or-pay clause is a contractual provision that requires a ". . . pipeline, over a stated period of time, to take an average amount of gas, or to pay for it." *FPC v. Sunray DX Oil Co.*, 391 U.S. 9, 47 n. 39 (1968); *see also Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 96 (5th Cir. 1966).[14] The prepaid gas is not lost to the purchaser but is normally subject to "makeup" or recoupment at a later date. A take-or-pay clause may be part of the bargained-for consideration in a long-term contract, and it provides the producer with reliable cash flow that it may depend upon to finance its production.

A take-or-pay clause in a contract with one producer may require the pipeline to take or pay for a certain percentage of that producer's deliverable capacity. Pipelines argue, however, that if ratable take then requires them to extend their takes to every other producer in the field at the same substantial percentages of

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12 The APPENDIX to this brief contains a list of recent authorities concerning the problems of ratable take, ratable production, and take-or-pay, including the opinions of the Oklahoma Corporation Commission and Texas Railroad Commission.

See also Hay & Williamson, Ratable Take, Take-or-Pay, Unilateral Price Adjustments, and Unilateral Market Out in STATE BAR OF TEXAS, SUING, DEFENDING AND NEGOTIATING WITH OIL & GAS PRODUCERS E-1 (1985). Cf. Note, supra note 2.

13 This litigation is based upon various producer arguments against ratable production. See notes 17-18 infra and accompanying text.

14 See also authorities cited in the APPENDIX, below.

deliverable capacity, they may be unable to market the gas so purchased. A take-or-pay clause with one producer may prevent the pipeline from lowering the percentage take, and thus it may be unable to avoid what it regards as excessive purchases from other producers under a ratable take requirement.[15] Pipelines claim that allowable or ratable production can balance the market. Pipelines further argue that these concerns are increased when there is a gas "bubble" or oversupply, as there has recently been.[16] It is for these reasons that pipelines make arguments for "allowables" or ratable production, which limit the quantity each producer can produce, instead of ratable take.

There are several aspects of the Mississippi approach that lessen these problems. First, the price at which ratable taking from other producers is done is not regulated except by a standard of good faith. Thus a pipeline such as Transco is not bound to pay the same price to others in the field, but may take into account market conditions, and it may thus balance supply and demand by taking at prices at which it knows that it *can* indeed resell. This feature of the Mississippi rule tends to minimize the problem of excessive takes. Furthermore, Mississippi places no other burdensome conditions upon takes of gas by pipelines. This rule preserves their flexibility completely and does not place any significant burden on purchases of gas in interstate commerce.

(2) Producer Arguments. Some producers further contest these pipeline arguments and argue that a scheme of ratable production should not be used to avoid the bargained-for effect of take-or-pay clauses or monthly minimums in their contracts. A producer may argue that it relies upon the cash flow assured by take-or-pay to finance the very production at issue. Alternatively, producers may argue that they have undertaken other subsequent exploration or production ventures in similar reliance

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15 But cf. Pierce, infra note 19, at 78-79.

16 In 1984, the lower-48-State gas "bubble" was estimated at 2.3 trillion cubic feet. FOSTER NAT. GAS REP. NO. 1470, June 14, 1984, at 10-11 (reporting American Gas Ass'n estimate).

on the contracted-for payments. In some cases, courts have granted temporary restraining orders to producers facing this problem. *Cf. Richardson Carbon & Gasoline Co. v. InterNorth, Inc.*, No. 4-38-534-K (N.D. Tex. Sept. 5, 1984), *reported in* Foster Nat. Gas Rep. No. 1483, Sept. 13, 1984, at 11. Producer insolvency could easily result in some such cases.[17]

Another problem is that, in some instances, reduced takes—whether caused by ratable production or by a pipeline's own action—can damage reservoirs. Thus in *Pogo Producing Co. v. Sea Robin Pipeline Co.*, No. 84-48823-H (Dist. Ct. Vermilion Parish, La., Feb. 21, 1985), *reported in* Foster Nat. Gas Rep. No. 1509, Mar. 21, 1985, at 7, a district court issued a temporary injunction to prevent a pipeline from reducing takes required by a monthly minimum clause because, as the court found, the partial shutdown of the water-drive wells at issue "has permanently damaged and will continue to damage the reservoirs since some of the gas can never be recovered."[18] In summary, producers may consider that their contract interests and reliance interests would be harmed by the required adoption of ratable production, which they argue avoids the anticipated effects of their agreements. *See also Southport Exploration Co. v. Producers Gas Co.*, No. 83-C-550B (N.D. Tex. June 6, 1984) (take or pay clause enforced).

This position is supplemented by the fact that, in some States, *both* ratable take and ratable production are required by rules. In such jurisdictions, the producer's production is limited by production limits, but pipelines are required to take ratably. In such a jurisdiction, mere ratable production is not enough to protect the producer against drainage because absent

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17 "In recent years, the judicial system has been inundated by litigation involving . . . insolvency in oil and gas operations." Stinnett, Contractual and Statutory Liens in the Oil Patch: Perfection and Foreclosure, in STATE BAR OF TEXAS , supra note 12, at D-1.

18 For a description of the problems of water-drive fields and ratable take, see Note, supra note 2, at 736 nn. 186-87.

a requirement of "fair-share" taking, the pipeline could take only from others in the field and refuse to take from a given producer. Thus the fact that each producer is subject to limits would provide no protection of the interest in fair-share takes.

(3) Federalism. The issue is complex, but at the very least it can be said that ratable production is not superior to ratable take for the purposes Mississippi seeks. A decision by Mississippi that ratable take is to be required simply cannot achieve the same objectives if replaced by a ratable production or "allowables" scheme. In a federal system, the negative commerce clause should not prohibit this choice. A constitutional rule should not determine the outcome unless the alternative is unambiguously superior.

II. STATES SHOULD NOT BE EMPOWERED TO PLACE ONEROUS BURDENS UPON INTERSTATE PIPELINES AND, IN PARTICULAR, SHOULD NOT BE ABLE TO REQUIRE PRICING UNRELATED TO ACTUAL PURCHASE CONDITIONS.

The Mississippi Supreme Court held that the state oil and gas board lacked statutory authority to require nondiscriminatory prices, meaning identical prices irrespective of purchase conditions. Although reached as a matter of state law, that decision also conformed to federal law. While this Court should uphold reasonable requirements of ratable take, it should also prevent States from imposing burdensome or irrational requirements on interstate pipelines, including requirements that they take at prices not reflecting existing market or contract conditions. These conclusions follow from the same authority analyzed to uphold ratable takes above, particularly the NGA, the NGPA, and the *Bruce Church* test.

Natural gas is typically sold on long-term contracts. Such contracts historically have been demanded not by producers, but by pipeline purchasers, who have sought a dependable source

of supply.[19] The length of the contract term is an important item of negotiation. A long term locks up supply for the purchasers, but it prevents the producer from selling elsewhere; hence a producer usually receives price consideration for entering into a long-term contract.[20] This contract feature, along with pricing terms, take-or-pay clauses, renegotiation clauses, and other provisions, all have an influence on the applicable price. So do such factors as well location and access, quality of gas, and ease of administration of the contract. Finally, market price varies with time; demand differs sharply with season, and price is heavily influenced by under- or over-supply.

A price that would burden an interstate pipeline's ability to consider these factors would not be "nondiscriminatory;" instead, it would be irrational. Producers who refused to enter into long-term contracts could "ride the market," seeking higher prices while assured of identical treatment to long-term sellers if prices fell. No producer would wish to commit supply. Furthermore, the difficulty of administering and complying with a state-level regulatory scheme that would set prices by reference to all relevant factors would be so burdensome that it would conflict with the NGA-NGPA scheme and with the *Bruce Church* test.

CONCLUSION

This honorable Supreme Court should not hold the rule at issue to be preempted by the NGA or NGPA. Nor should it hold the rule to be prohibited by the negative commerce clause. The rule serves important state interests that are not protected by federal law; its effects on interstate commerce

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19 See E. NEUNER, THE NATURAL GAS INDUSTRY 266-69 (1960); Pierce, Natural Gas Regulation, Deregulation, and Contracts, 68 VA. L. REV. 63, 77-78 (1982).

20 Thus Professor MacAvoy, in a study of gas contracts, found that longer term contracts were associated with higher prices. P. MACAVOY, PRICE FORMATION IN NATURAL GAS FIELDS 236-37 (1962); cf. Pierce, supra note 19, at 77-78.

and upon the objectives of federal law are diffuse and indirect, and they are not the purpose of the rule; and its objectives cannot be achieved equally by an approach with lesser impact on interstate commerce. At the same time, however, the Court should not broadly sanction state regulation that would unduly burden interstate pipelines. In particular, a requirement that a pipeline take at identical prices from each producer irrespective of existing market conditions would be irrational and should not be authorized.

Respectfully submitted,

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APPENDIX

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